

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between the property's \$630,000 adjusted tax basis and its \$900,000 book value, in accordance with § 1.704-1(b)(2)(iv)(f) and the special rule contained in § 1.704-1(b)(4)(i).

(b) *Effect of revaluation.* Because the requirements of § 1.704-1(b)(2)(iv)(g) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with § 1.704-1(b)(2)(iv). If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain (\$700,000 amount realized less \$900,000 book value). As a result of the revaluation of the machinery upward by \$270,000, under part (i) of paragraph (d)(4) of this section, the partnership minimum gain is reduced from \$70,000 immediately prior to the revaluation to zero; but under part (ii) of paragraph (d)(4) of this section, the partnership minimum gain is increased by the \$70,000 decrease arising solely from the revaluation. Accordingly, there is no net increase or decrease solely on account of the revaluation, and so no minimum gain chargeback is triggered. All future nonrecourse deductions that occur will be the nonrecourse deductions as calculated for book purposes, and will be charged to all 3 partners in accordance with the partnership agreement. For purposes of determining the partners' shares of minimum gain under paragraph (g) of this section, A's and B's shares of the decrease resulting from the revaluation are \$35,000 each. However, as illustrated below, under section 704(c) principles, the tax capital accounts of A and B will eventually be charged \$35,000 each, reflecting their 50 percent shares of the decrease in partnership minimum gain that resulted from the revaluation.

(iii) *Allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Ad-*

*ditional facts.* During the partnership's third taxable year, the partnership generates rental income of \$130,000, interest expense of \$70,000, a tax depreciation deduction of \$210,000, and a book depreciation deduction (attributable to the machinery) of \$300,000. As a result, the partnership has a net taxable loss of \$150,000 and a net book loss of \$240,000. In addition, the partnership repays \$50,000 of the nonrecourse liability (after the data of C's admission), reducing the liability to \$650,000 and distributes \$5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, \$50,000 of book gain would result (\$650,000 amount realized less \$600,000 book basis). Therefore, the amount of partnership minimum gain at the end of the year is \$50,000, which represents a net decrease in partnership minimum gain of \$20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to paragraph (d)(4) of this section, the amount of nonrecourse deductions of the partnership for its third taxable year is \$50,000 (the net increase in partnership minimum gain during the year determined by adding back the \$70,000 decrease in partnership minimum gain attributable to the revaluation of the machinery to the \$20,000 net decrease in partnership minimum gain during the year). The \$50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of \$50,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of \$240,000, including the \$50,000 nonrecourse deduction, are allocated equally among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704-1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of \$210,000 for the partnership's third taxable year is, in accordance with section 704(c) principles, shared \$55,000 to A, \$55,000 to B, and \$100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	(\$35,000)	\$100,000	(\$35,000)	\$100,000	\$100,000	\$100,000
Less: nonrecourse deductions	(9,166)	(16,666)	(9,166)	(16,666)	(16,666)	(16,666)
Less: items other than nonrecourse deductions in year 3	(25,834)	(63,334)	(25,834)	(63,334)	(63,334)	(63,334)
Less: distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 3 .....	(\$75,000)	\$15,000	(\$75,000)	\$15,000	\$15,000	\$15,000

Because the requirements of paragraph (e) of this section are satisfied, the allocation of the nonrecourse deduction is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, A's, B's, and C's shares of partnership minimum gain are \$16,666 each.

(iv) *Subsequent allocation of nonrecourse deductions following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the second and third taxable years of the partnership are as stated in *Example 3(iii)* of this paragraph (m). In addition, during the partnership's fourth taxable year the partnership generates rental income of \$130,000, interest expense of \$65,000, a tax depreciation deduction of \$210,000, and a book depreciation deduction (attributable to the machinery) of \$300,000. As a result, the partnership has a net taxable loss of \$145,000 and a net book loss of \$235,000. In addition, the partnership repays \$50,000 of the nonrecourse liability, reducing that liability to \$600,000, and distributes \$5,000 of cash to each partner.

(b) *Allocations.* If the partnership were to dispose of the machinery in full satisfaction

of the nonrecourse liability at the end of the fourth year, \$300,000 of book gain would result (\$600,000 amount realized less \$300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is \$300,000, which represents a net increase in partnership minimum gain during the year of \$250,000. Thus, the amount of partnership nonrecourse deductions for that year equals \$250,000, consisting of book depreciation deductions of \$250,000. Pursuant to the partnership agreement, all partnership items comprising the net book loss of \$235,000, including the \$250,000 nonrecourse deduction, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in § 1.704-1(b)(4)(i), the partnership agreement provides that the depreciation deduction for tax purposes of \$210,000 in the partnership's fourth taxable year is, in accordance with section 704(c) principles, allocated \$55,000 to A, \$55,000 to B, and \$100,000 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end year 3 .....	(\$75,000)	\$15,000	(\$75,000)	\$15,000	\$15,000	\$15,000
Less: nonrecourse deductions .....	(45,833)	(83,333)	(45,833)	(83,333)	(83,333)	(83,333)
Plus: items other than nonrecourse deduction in year 4 .....	12,499	5,000	12,499	5,000	5,000	5,000
Less: distribution .....	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 4 .....	(\$113,334)	(\$68,333)	(\$113,333)	(\$68,333)	(\$68,333)	(\$68,333)

The allocation of the \$250,000 nonrecourse deduction equally among A, B, and C satisfies requirement (2) of paragraph (e) of this section. Because all of the requirements of paragraph (e) of this section are satisfied, the allocation is deemed to be in accordance with the partners' interests in the partnership. At the end of the partnership's fourth taxable year, A's, B's, and C's shares of partnership minimum gain are \$100,000 each.

(v) *Disposition of partnership property following restatement of capital accounts.* (a) *Additional facts.* The partners' capital accounts at the end of the fourth taxable year of the partnership are as stated above in (iv). In addition, at the beginning of the partnership's fifth taxable year it sells the machinery for \$650,000 (using \$600,000 of the proceeds to repay the nonrecourse liability), resulting in

a taxable gain of \$440,000 (\$650,000 amount realized less \$210,000 adjusted tax basis) and a book gain of \$350,000 (\$650,000 amount realized less \$300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for the year.

(b) *Effect of disposition.* As a result of the sale, partnership minimum gain is reduced from \$300,000 to zero, reducing A's, B's, and C's shares of partnership minimum gain to zero from \$100,000 each. The minimum gain chargeback requires that A, B, and C each be allocated \$100,000 of that gain (an amount equal to each partner's share of the net decrease in partnership minimum gain resulting from the sale) before any allocation is made to them under section 704(b) with respect to partnership items for the partnership's fifth taxable year. Thus, the allocation

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of the first \$300,000 of book gain \$100,000 to each of the partners is deemed to be in accordance with the partners' interests in the partnership under paragraph (e) of this section. The allocation of the remaining \$50,000 of book gain equally among the partners has substantial economic effect. Consistent with

the special partners' interests in the partnership rule contained in § 1.704-1(b)(4)(i), the partnership agreement provides that the \$440,000 taxable gain is, in accordance with section 704(c) principles, allocated \$161,667 to A, \$161,667 to B, and \$116,666 to C.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 4 .....	(\$113,334)	(\$68,333)	(\$113,334)	(\$68,333)	(\$68,333)	(\$68,333)
Plus: minimum gain chargeback .....	138,573	100,000	138,573	100,000	100,000	100,000
Plus: additional gain .....	23,094	16,666	23,094	16,666	16,666	16,666
Capital account before liquidation .....	\$48,333	\$48,333	\$48,333	\$48,333	\$48,333	\$48,333

*Example 4. Allocations of increase in partnership minimum gain among partnership properties.* For *Example 4*, unless otherwise provided, the following facts are assumed. A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property W of \$10,000 and repays \$5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of \$5,000. Second, the partnership generates a depreciation deduction (for both book and tax purposes) with respect to Property X of \$10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of \$10,000. Third, the partnership generates a depreciation deduction (for both book and tax purposes) of \$2,000 with respect to Property Y and repays \$11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of \$9,000 (although at the end of that year, there remains minimum gain with respect to that liability). Finally, the partnership borrows \$5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, a parcel of undeveloped land with an adjusted tax basis (and book value) of \$2,000, resulting in a net increase in minimum gain with respect to that liability of \$3,000.

(i) *Allocation of increase in partnership minimum gain.* The net increase in partnership minimum gain during that partnership taxable year is \$9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is \$9,000. Those nonrecourse deductions consist of \$3,000 of depreciation deductions with respect to Property W and \$6,000 of depreciation deductions with respect to Property X. See paragraph (c) of this section. The amount of nonrecourse de-

ductions consisting of depreciation deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, for which there is no depreciation deduction, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is no increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are secured by property for which there are depreciation deductions and for which there is an increase in minimum gain, the amount of depreciation deductions that constitutes nonrecourse deductions is determined by the following formula:

net increase in the partnership minimum gain for that taxable year X total depreciation deductions for that taxable year on the specific property securing the nonrecourse liability to the extent minimum gain increased on that liability (divided by) total depreciation deductions for that taxable year on all properties securing nonrecourse liabilities to the extent of the aggregate increase in minimum gain on all those liabilities.

Thus, for the liability secured by Property W, the amount is \$9,000 times \$5,000/\$15,000, or \$3,000. For the liability secured by Property X, the amount is \$9,000 times \$10,000/\$15,000, or \$6,000. (If one depreciable property secured two partnership nonrecourse liabilities, the amount of depreciation or book depreciation with respect to that property would be allocated among those liabilities in accordance with the method by which adjusted basis is allocated under paragraph (d)(2) of this section.)

(ii) *Alternative allocation of increase in partnership minimum gain among partnership properties.* Assume instead that the loan secured by Property Z is \$15,000 (rather than \$5,000), resulting in a net increase in minimum gain with respect to that liability of \$13,000. Thus, the net increase in partnership minimum